

NOT INTERESTED IN INTEREST? THE CASE FOR EQUITY-BASED FINANCING IN U.S. BANKING LAW

HUDA AHMED*

Muslim entrepreneurs are faced with a religious dilemma in financing their businesses because of incompatibilities between traditional loan financing and Islamic law. This note articulates the need for change in the banking industry and makes a proposal to harmonize the financing needs of Muslim entrepreneurs with established banking law. The accommodation proposed modifies existing banking law to enable Muslim entrepreneurs to finance their business ventures in a manner compliant with their religious beliefs. Specifically, an amendment is proposed to the Federal Deposit Insurance Corporation Improvement Act of 1991 that allows, in some restricted circumstances, for banks to arrange and participate in equity financing transactions for and with Muslim entrepreneurs.

I. INTRODUCTION

Imagine two similarly situated entrepreneurs. Both are middle aged, middle-class with families, and both want to open a diner in their hometown. One of the entrepreneurs is Belaal and the other is Bob. Belaal is a Muslim; Bob is not. After developing their business plan and finding a site, both Bob and Belaal need capital to buy land and equipment for their business. Bob goes to his local bank and arranges for a small business loan. He takes the money from the loan and uses it to purchase land and equipment for the diner. For Belaal, however, a small business loan is not an option because the interest-bearing loan does not comply with his religious beliefs.

Like Belaal, many Muslim entrepreneurs have special difficulty financing their businesses because traditional vehicles for small business financing in the United States do not comply with Islamic tenets. The problem for Muslim entrepreneurs is that traditional loan transactions

* J.D. The Ohio State University Moritz College of Law, expected 2007. I dedicate this Note to my parents, who gave me a life more beautiful than my dreams. I also dedicate this Note to my siblings, Sameera, Nadeem, Amera, Yusuf, Kamran and Somi, for their constant encouragement, good humor, and open arms. I would like to thank Justin Finn, Adam Webber, and Professor Elizabeth Anstaett for their invaluable advice and assistance in developing this Note.

involve interest-based financing, which runs afoul of Islamic Law.¹ The lack of acceptable financing presents a serious problem for Muslim entrepreneurs who are faced with a religious dilemma when choosing between a loan for their business or adhering to religious principles and using cash to finance their business ventures.

This religious dilemma stems from incompatibilities between traditional loan financing and Islamic law.² Islamic law, also known as Shariah, consists of the Quran, the teachings and traditions of the Prophet Muhammed, and a consensus of scholars who interpret religious principles and apply these principles to modern issues.³ Shariah, the body of Islamic law contains spiritual guidance for believing Muslims as well as guidelines for governance of a society.⁴ Among the societal guidelines in Shariah are rules that govern trade and business affairs.⁵ These guidelines are discussed more thoroughly in the following section entitled "Principles of Islamic Banking and Finance." The most commonly known principal of

¹ VIRGINIA B. MORRIS & BRIAN D. INGRAM, GUIDE TO UNDERSTANDING ISLAMIC INVESTING 10 (Karen Meldron & Mavis Mors eds., 2001). Interest is seen by some as a form of usury. Jewish and Christian scriptures have also traditionally prohibited charging or collecting usury as illustrated in the following selected verses.

If one of your brethren becomes poor, and falls into poverty among you, then you shall help him, like a stranger or a sojourner, that he may live with you. Take no usury or interest from him; but fear your God, that your brother may live with you. You shall not lend him your money for usury, nor lend him your food at a profit. I am the lord your God, who brought you out of the land of Egypt, to give you the land of Canaan and to be your God. Leviticus 25:35-38.

Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything that is lent upon usury.

Deuteronomy 23:19.

Thou oughtest therefore to have put my money to the exchanges, and then at my coming I should have received mine own with usury.

Mathew 25:27.

² MORRIS & INGRAM, *supra* note 1, at 10. One of the principles used to interpret the Shariah relies on the hierarchy of Islamic sources of law. The four sources of Islamic law from most authoritative to least are: the Quran, the Sunnah, consensus of Muslim scholars, and analogy. The Quran is the primary source of Islamic law. Muslims believe the Quran as revealed to the Prophet Muhammed is the word of God and has remain unchanged from it revelation until today. The Sunnah consists of the sayings and actions of the Prophet. When there is a consensus of Muslim scholars on a subject or issue of law, that consensus is presumptively valid. Finally, when the first three sources do not shed light on an issue, analogy is used to come to a legal conclusion. *Id.* at 7.

³ FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 23 (1998).

⁴ *Id.*

⁵ *Id.*

Islamic finance is the prohibition of interest.⁶ Practicing Muslims adhere to the rules of Shariah very closely because they believe in accountability in the hereafter.⁷

This paper articulates the need for a religious accommodation in the banking industry. The accommodation proposed does not purport to make any radical changes to existing law or the banking regulatory scheme; all that is recommended is a minor accommodation to enable Muslim entrepreneurs to finance their business ventures in a manner compliant with Islamic law. Specifically, an exception needs to be added to the Federal Deposit Insurance Act of 1991 (“FDICIA”)⁸ that allows, in some restricted circumstances, for banks to arrange and participate in equity financing transactions for and with Muslim entrepreneurs.⁹ The accommodation sought is a narrow one, large enough to allow for the accommodation of Muslim-friendly financing vehicles, but small enough that the traditional practices and balances of the banking industry are undisturbed.

II. THE MUSLIM FINANCING DILEMMA AND PROPOSED SOLUTION

While Belaal might choose to forego the small business loan option, not all Muslims follow suit. Like followers of all religions, Muslims practice Islam to varying degrees. Some Muslims do not adhere to Islam’s prohibition on interest and obtain interest-bearing loans. Other Muslims try to avoid interest-bearing loans, but are in situations where such loans are necessary. These Muslims that obtain traditional loans may feel badly about their actions, but see no other option given their situation. Finally, there are Muslims who adhere strongly to Islam’s prohibition on interest and refuse to take out interest-bearing loans. These Muslims finance their purchases with cash. As entrepreneurs, these Muslims often sell off assets and borrow from family and friends to acquire the necessary capital to start-up a business. What all of this means in the entrepreneurial environment is that Muslims who adhere strongly to the rules of Shariah simply do not pursue business ventures unless they have enough capital on hand to finance the venture, a near impossible task.

The Muslim entrepreneur-financing dilemma presents many difficult problems for Muslim Americans. The most obvious is that Muslim entrepreneurs have to raise a larger amount of capital themselves in order to

⁶ *Id.* at 2.

⁷ *Id.* at 23.

⁸ Federal Deposit Insurance Corporation Act, 12 U.S.C. § 1831 (2001).

⁹ A similar accommodation has already been allowed by the Office of the Comptroller of Currency OCC in the context of home ownership. An interpretive letter responding to a request by the Bank of Kuwait allows banks to enter into “net leases of real estate to serve the home finance needs of its Muslim customers, who are prohibited by religious principles from obtaining traditional mortgages.” Interpretive Letter No. 806, Office of the Comptroller of Currency (Oct. 17, 1997).

get their businesses off the ground, whereas their non-Muslim competitors can rely on the capital infusion of a small business loan. Muslim entrepreneurs who wish to comply with financing principles outlined in Shariah are then at a competitive disadvantage because they do not have the financing options that are available to others. These entrepreneurs have to raise or generate the amount of cash necessary to meet their business needs, whereas non-Muslim entrepreneurs only have to generate an amount necessary to service their debt obligations, a fraction what their Muslim counterparts have to raise, simply because of the accessibility of small business loans.

Another problem of the Muslim entrepreneur-financing dilemma is that the inaccessibility of Islamic-friendly financing prohibits Muslim-owned businesses from starting-up with as much ease as non-Muslim owned businesses. Muslim-owned businesses are, therefore, at a higher risk of failure because they must have sufficient cash flow to meet all of their needs all of the time. The lack of Shariah-compliant financing options available to Muslim entrepreneurs means that some business ventures, although potentially successful and beneficial to the public, are likely never pursued because the entrepreneurs who would pursue these ventures cannot finance them.

Muslim entrepreneurs deserve financing opportunities that do not violate their religious beliefs. Financing vehicles can be created that allow for Muslim-friendly equity financing at low risk and adequate profitability for banks. Banks would benefit from the business of Muslim entrepreneurs who have otherwise been using cash to finance transactions. Consumers and the economy would also benefit from the increased business activity and a broader offering of goods and services.

Although the legal system in the United States is secular, our society has made accommodations in the past for citizens to practice their respective religions and cultures. Most Christian citizens are not made to work on Christmas. Jewish and Muslim employees are often given religious holidays off when requested. Jewish observers of the Sabbath are also accommodated in work and academic settings and can even take standardized tests on alternate days. The global airline industry has also made religious accommodations. Jewish travelers can request kosher meals, Muslim travelers can request Muslim meals, and Hindu travelers can request vegetarian meals. The food and drug industry has also made accommodations for religions. Jewish consumers are offered food items that are kosher compliant and sealed with the kosher "K."

Religious accommodations are minor and are hardly noticed by mainstream society. The sight of the kosher "K" does not offend the average American, nor is the average American offended by the food options that airlines offer. Serving niche populations by crafting products tailored to minority consumers permits companies to capture profits from previously untapped consumer pools. Likewise, minority consumers

benefit from specially crafted goods and services because the new products and services enable thoughtful integration in the marketplace.

III. PRINCIPLES OF ISLAMIC BANKING AND FINANCE

There are about 1.3 billion Muslims worldwide and roughly 7 million in North America.¹⁰ Muslims constitute about 20% of the global population and such a presence creates significant demand for acceptable banking services.¹¹ The demand created by Muslims seeking religiously compatible banking services has led to the development of Islamic banking products and services within the global banking industry to meet the needs of Muslims who adhere to Islamic law. The following discussion will touch on the current landscape of Islamic banking by highlighting recent developments, it will illustrate Islamic banking's inaccessibility to Muslim entrepreneurs living in the States, and it will outline the general principles of Islamic finance.¹²

A. *Islamic Banking Today*

Islamic banking is a growing field that acknowledges the Quran's prohibition of interest within the banking industry in order to provide banking services to the global Muslim community.¹³ Islamic banking develops services and structures transactions in ways that do not use interest, but are still beneficial to consumers and yield a profit for banks.¹⁴ For example, Islamic banking services facilitate profit-sharing transactions where the risk of the transaction is shared between both parties to the transaction. Profit-sharing transactions are an alternate financing model whereby a bank will make an equity investment in the business venture and

¹⁰ CIA World Factbook, *available at* <https://www.odci.gov/cia/publications/factbook/geos/xx.html#People> (last visited Apr. 14, 2007).

¹¹ *Id.*

¹² Islamic banking is a term that has come about to describe banking and financing practices that are compliant with Shariah.

¹³ *Principles of Islamic Banking*, NIDA'UL ISLAM MAGAZINE, Nov.-Dec., 1995, *available at* <http://www.usc.edu/dept/MSA/economics/nbank1.html>; Quran 2: 275-279.

¹⁴ Countries with predominantly Muslim populations provide Islamic banking services to various degrees. Services provided by different countries can be grouped as follows:

[1] those [countries] that have transformed their entire internal financial systems to an Islamic form (Iran, Pakistan, and Sudan); [2] those that embrace Islamic banking as a national policy while supporting dual banking tracks (Bahrain, Brunei, Kuwait, Malaysia, Turkey, United Arab Emirates); [3] those that neither support nor oppose Islamic banking within their jurisdictions (Egypt, Yemen, Singapore, and possibly Indonesia); and [4] those that actively discourage a separate Islamic banking presence (Saudi Arabia and Oman).

VOGEL & HAYES, *supra* note 3, at 11.

share in the venture's profits and risk. The profit-sharing method and other financing vehicles created by the Islamic banking industry make comparable financing alternatives available for Muslim entrepreneurs that are compliant with Islamic law and enable Muslim businesses to be competitive in the marketplace.

Outside the U.S., the needs of Muslim entrepreneurs have been met by an expanding sub-segment of the global banking industry. The field of Islamic banking is developing with great momentum.¹⁵ Today, there are over 250 banks operating worldwide that offer Islamic banking services, with an aggregate of over 200 billion U.S. dollars in deposits.¹⁶ Naturally, most countries with predominantly Muslim populations provide Islamic banking services.¹⁷ However, other countries that have large minority Muslim populations also provide Islamic banking services.¹⁸ Countries such as Australia, Italy, Russia, South Africa, Switzerland, and the U.K. have found it both necessary and beneficial to service the banking needs of their resident Muslim populations.¹⁹ Indeed, most countries are providing their Muslim citizens with Islamic banking options without harm or disruption befalling their own banking industries.²⁰ The United States commercial banking sector, however, is lagging behind in the field of Islamic banking.²¹

¹⁵ See, e.g., *Id.* at 11.

¹⁶ THE INSTITUTE OF ISLAMIC BANKING AND INSURANCE, ISLAMIC BANKING – STATUS OF ISLAMIC BANKING, available at <http://www.islamic-banking.com/ibanking/statusib.php> (last visited Mar. 5, 2006).

¹⁷ The three countries with complete Islamic economies are: Pakistan, Iran, and Sudan. VOGEL & HAYES, *supra* note 3, at 5.

¹⁸ *Id.*

¹⁹ *Islamic Banking*, *supra* note 13.

²⁰ *Id.* In fact, Islamic banks had grown at an average rate of 15% per year in the years 1993-1998. See also, VOGEL & HAYES, *supra* note 3, at 5.

²¹ To be fair, Islamic banking has made somewhat of an appearance in the United States. Some American banks that have instituted Islamic finance operations include: Citibank and Chase Manhattan Bank. See also VOGEL & HAYES, *supra* note 3, at 6-7. European banks embraced the Islamic Finance model with much more zeal. See HSBCAmana, <http://www.hsbcamanah.com/hsbc/amanah>. Moreover, Islamic investment companies and home finance companies have emerged to fill the void the banking industry has left. See generally www.guidancefinancial.com. See also www.amanafunds.com. To the extent the services provided by these companies are banking services, Islamic banking has been incorporated into the American banking system. However, Islamic banking in the traditional sense of providing financing, still remains unavailable to Muslims. American-Muslim entrepreneurs do not have access to Islamic banking services because their local or regional bank does not provide such services. Muslim business owners would benefit from the development of Islamic banking because it would provide financing options for asset and land acquisitions necessary for business start-ups that are compliant with Shariah.

B. Principles of Islamic Finance

The general consensus of Muslim scholars is that the use of interest in today's global banking system runs afoul of Islamic financing principles because interest is a form of usury.²² One illustrative verse in the Quran states "O you who believe! Fear Allah and give up that remains of your demand for usury, if you are indeed believers."²³ The Arabic term used in this verse and others is "Riba."²⁴ Riba is best translated to mean "to grow or to increase."²⁵

Muslim scholars have interpreted Riba within Islamic law to mean "excess" in the context of a transaction, such that one party receives more either in price or quantity than the other party.²⁶ Riba is most often found in exchange transactions such as sales, purchases, swaps, or loans. Muslim scholars have come to the general consensus that Riba is a comprehensive term that includes, but is not limited to, interest.²⁷ The reasoning most often given for the ban on Riba is that it is a predatory and exploitative practice where one party is unjustly enriched at the expense of the other party.²⁸ Other reasons given for the ban on Riba is that it prevents parties from contracting on equal terms and overall risk in these transactions is unevenly distributed.²⁹

For example, in an interest-bearing loan the lender is guaranteed a profit regardless of whether the borrower makes a gain or loss on the funds provided by his loan. In this example, the borrower shoulders a majority of the transaction's risk. In contrast, the borrower bears all of the risk and will have to repay the loan and interest before he can make any profit for himself. Traditional loan transactions are seen as exploitative because the borrower should not be the sole bearer of the transaction's risk. In the context of entrepreneur financing, entrepreneurs are, in many instances, the "little guy." Entrepreneurs do not have the assets, cash, or established revenue stream that banks have to cushion adverse business conditions or unforeseen events. Therefore, a business failure will have a disproportionately adverse effect on the entrepreneur. In contrast, banks are more established and will be harmed to a much lesser extent than individual entrepreneurs. This is not to say that banks should bear all or even most of a transaction's risk merely because they are best situated financially to do so. Islamic finance principles merely prohibit the "all or nothing" component of the traditional loan. Islamic compliant loan transactions

²² MORRIS & INGRAM, *supra* note 1, at 10.

²³ Quran, 2:275-279.

²⁴ MORRIS & INGRAM, *supra* note 1, at 10.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

allow for the lender to have a return on investment similar to the prevailing interest rate; however, the “loan” is an investment in a land or asset so that if the business venture fails, the lender is still left with equity in the property that can be liquidated to recoup its initial investment.³⁰

C. Practical Guidelines in Islamic Financing

The ban on Riba in Islamic law gives rise to five practical guidelines to structure transactions in compliance with Islamic law. The first guideline is that predetermined payments over the principal amount are not allowed.³¹ An example of a prohibited transaction under this guideline is a traditional loan transaction where the borrower repays the lender with principal plus interest. The interest in the transaction is prohibited because it is a predetermined payment over the principal amount.³² The only loans that are admissible are those loans where the lender charges the borrower only for the amount of money lent. The lender is still entitled to a share of the venture’s profits.³³

³⁰ VOGEL & HAYES, *supra* note 3 at 140-141

³¹ *Principles of Islamic Banking*, *supra* note 13. The rationale behind this practical guideline stems from the general prohibition of usury. Usury is seen as exploitative and that is why it is prohibited. The repayment of a predetermined amount in addition to the principal is seen by many as one such form of exploitation. MORRIS & INGRAM, *supra* note 2, at 10.

³² Co-authors and members of the Harvard Islamic Finance Project, Frank Vogel and Samuel Hayes explain the subtle differences in Islamically permissible and impermissible transactions with respect to the prohibition on predetermined payments over the principal. Their explanation provides in relevant part,

[I]t is widely known that Islamic finance prohibits the charging of interest on loans. But most do not know that Islamic law does not reject the notion of the time value of money. The capital provider is permitted an adequate return. For instance: If money is committed to another party to use for a period of time, compensation for the financing may not be a predetermined amount guaranteed by the other party to the contract; instead, it should be a share in the actual profits of the venture. Money is not treated as a commodity, as in the West, but as a bearer of risk, and therefore subject to the same uncertainties as those borne by other partners in the enterprise. If investors finance the acquisition of tangible goods by sale or lease, they may legitimately compensate themselves for foregone opportunities. Profits deriving from lease payments or from credit sale may reflect, even explicitly, a time factor.

VOGEL & HAYES, *supra* note 3, at 2.

³³ Banks engaging in Islamic finance transactions may still earn a profit on the transaction. The profit earned may come from either a profit share in the venture being financed, or may be to compensate the bank for the time value of money on the

This concept has also been extended to non-cash benefits that the borrower may provide to the lender.³⁴ Specifically, this extension applies where the borrower gives the lender non-monetary goods or services instead of interest payments. In instances where non-cash benefits in excess of the principal are paid to the lender, those benefits are considered interest payments and consequently run afoul to the principal just discussed.

The second guideline in Islamic financing is a more specific and explicit extension of the first guideline and is the prohibition of earning money on money.³⁵ The previous example applies in this case as well because the interest in a loan transaction is the profit the lender derives from the money lent. Islamic law treats money as a medium of exchange.³⁶ For the purposes of Islamic finance, money defines the value of a good or service but lacks inherent value itself.³⁷ It is treated as a source of potential capital, but not capital itself, because the business venture is of more value than the cash used to finance the venture.³⁸ This principal is a departure from generally established customs of mainstream banking where cash is considered an asset and a source of capital. According to Shariah, however, in order for money to be legitimately made on money, there must be an intermediate step where value is added or the money is converted to a good or service.³⁹

A profit-sharing method, as discussed below, satisfies the value adding intermediate step requirement. As we will see in more detail below, the profit-sharing method requires that a bank will provide a borrower with capital for land or asset acquisition purposes. Upon receiving the capital

opportunity cost of investments not pursued. The term often used to describe such profit is "profit banking." *Id.*

³⁴ *Principles of Islamic Banking*, *supra* note 13.

³⁵ *Id.*

³⁶ As previously stated, Islamic Law does not allow money to be made on money. Rather, money is used to facilitate transactions.

Islam ... does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; each unit of money is 100 per cent equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units *inter se*. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged, one for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, financing in Islam is always based on non-liquid asset which creates real assets and inventories.

MUHAMMAD TAQI USMANI, AN INTRODUCTION TO ISLAMIC FINANCING XIV-XV (2001).

³⁷ *Id.*

³⁸ *Principles of Islamic Banking*, *supra* note 13.

³⁹ *Id.*

and purchasing the land or asset the borrower will have to repay the bank. The intermediate step in the scenario is the actual purchase of the land or asset. The capital lent to the borrower is tied to or converted into property. Then, when a bank charges the lender a markup or profit rate—that is an amount exceeding the principal lent—the resulting payment is not interest on the actual money lent. Although the example given closely resembles interest there is a subtle difference. In a traditional loan the excess amount paid over the principal is a charge on the actual money lent: money is made on money. In a profit-sharing method the excess amount paid over the principal is the lender's return on investing in the land or asset purchased.⁴⁰

The third guideline is that the risk involved in the enterprise must be shared between both parties in the transaction.⁴¹ For example, the traditional small business loan would violate this principal. In a traditional small business loan where the bank lends an entrepreneur money to finance his business venture the bank will be repaid the principal and interest on the loan regardless of the success of the business venture. The parties in small business loan transactions have unequal bargaining positions because they do not share equally in the risks of the venture. In the banking context, this rule means that the lender and borrower should share the same risks and profits from business ventures.

Islam encourages investment because investing provides benefits to the community at large. Investing in high-risk high-return ventures is a value adding benefit to society. With a profit-sharing method in place, banks have an incentive to make sound investments because they will reap a portion of the profits. Muslim entrepreneurs benefit from a religiously acceptable financing vehicle for their business venture and society benefits from the goods and services of the business. Without profit-sharing banking, Muslim entrepreneurs are forced to either self-finance their business ventures with cash—an almost impossible feat for all but the very wealthy—or forego entrepreneurship. Pursuing risky ventures backed with bank financing will result in profit as well as goods and services for the community, whereas foregoing investment will result in loss from money devaluation.⁴²

The fourth guideline in Islamic financing is that speculation is prohibited. Parties who enter into a transaction must know exactly what values are being exchanged. Therefore, the values exchanged cannot be subject to speculation, uncertainty, or undue risk. An example of a prohibited transaction would be one where a lender loans money to a borrower who in turn promises to pay the borrower the principal plus an amount to account for inflation. The uncertainty of the inflation protection

⁴⁰ Islamic law recognizes leveraging opportunities and does not require complete equity financing in a firm's capital structure. VOGEL & HAYES, *supra* note 3, at 2.

⁴¹ *Id.*

⁴² *Id.*

violates this fourth rule because it is an undetermined amount. Parties that enter into a transaction need to know the exact items, amounts, or rates being exchanged. A contract that calls for a portion of the fee to be determined at a later time will be void based on this uncertainty principle because one of the parties is open to exploitation by the other party. The motivations behind this rule are mainly equitable: if a provision of a contract is left open to be determined after contract signing, one of the parties could potentially take unfair advantage of the other party through that provision. This rule is meant to prevent such events.

The fifth and final guideline of Islamic finance requires that Muslims engage in socially responsible investments and transactions.⁴³ While this aspect of Islamic finance will not be the focus of our discussion, the implication of this principle is that Muslim entrepreneurs should pursue business ventures that have social value and are not harmful to society. As many Muslims do not live within Islamic law jurisdiction this rule cannot really be enforced per se, but Muslim entrepreneurs are left to their own moral intuitions when complying with this guideline.

IV. TRADITIONAL ISLAMIC TRANSACTIONS

Muslim business owners throughout the centuries have been financing their businesses through various transactions that are compliant with Islamic law. The two most common transaction structures are the Murabaha transaction and the Ijara transaction.⁴⁴

A. *The Murabaha Transaction*

A Murabaha transaction is a deferred payment sale that resembles an installment sales contract.⁴⁵ A business owner who chooses the Murabaha method of financing will have a bank acquire title to the desired property or asset from the seller. The bank will then transfer title to the business owner either at the initial closing or at a later agreed upon date.⁴⁶ This transaction allows the seller and business owner to come to a mutual agreement on a markup over the actual asset price and allows the business owner to make payments over a period of time.⁴⁷

⁴³ MORRIS & INGRAM, *supra* note 1, at 8.

⁴⁴ ABDULKADER THOMAS, METHODS OF ISLAMIC HOME FINANCE 5(2004), *available at* http://www.guidancefinancial.com/pdf/Islamic_HFUS.pdf.

⁴⁵ *Id.* at 5.

⁴⁶ *Id.*

⁴⁷ [The Murabaha] transaction has many advantages. First, ordinarily no bank engages in trading in goods, finding this enterprise too risky and distracting. But this commissioned *murabaha* enables the bank to avoid the drawbacks of trading: it never purchases unless it already has an assured buyer, who moreover informs the bank how to obtain the goods it wants. Second, while the bank's profit (the markup) conceivably derives in part from its services in securing the goods through the first sale, it is far

Although the Murabaha transaction resembles a traditional loan there is a subtle difference. In a traditional loan transaction the lender has an advantage over the borrower and the risk distribution of the transaction is unequal.⁴⁸ The lender is guaranteed a profit from the transaction whether the business owner makes a profit or loss, whereas the business owner is not guaranteed a profit or loss from the business.

The Murabaha transaction is acceptable because it requires an intermediate step where the money borrowed is either used for the purchase of goods or services or is used to invest in a business venture.⁴⁹ It is better understood if broken into two steps. In the first step the money is borrowed to finance the purchase of an asset or land. In the second step that land or asset is used to produce profit, a portion of which is returned to the lender along with periodic payments on the principal.⁵⁰ The profit amount returned to the bank is an agreed upon rate that is predetermined before the parties enter into the transaction. The profit rate is similar to an interest rate, but technically different because it is actually an investment return on the asset or land purchase.

The Murabaha transaction, while on its face may appear the same as a traditional loan, can be considered traditional profits from trade.⁵¹ In the illustration of Murabaha transactions above, note that the bank first buys the property and then sells it to the business owner for a profit. In this way, the property is treated as any other traded good. The amount in excess of the principal that is returned to the lender is considered a return on investment from the asset or land invested. In contrast, in a traditional business loan lacking the intermediate value-adding step, the amount in excess of the principal is the fee charged for use of the money. The principles of Islamic finance explicitly state that money made on money is prohibited, but that money made from trade is lawful. The crux of the

more likely—especially in the present day—to derive from the extension of credit in the second sale. To the extent that the bank's services in carrying out the two sales and the costs and risks of its interim ownership can be minimized, the transaction becomes economically very similar to a conventional commercial loan. VOGEL & HAYES, *supra* note 3, at 140-141.

⁴⁸ MORRIS & INGRAM, *supra* note 2, at 10.

⁴⁹ Banque Saudi Fransi, Shari'a Compliant Investments, http://www.alfransi.com.sa/wps/portal/!ut/p/.cmd/cs/.ce/7_0_A/.s/7_0_L4/_s.7_0_A/7_0_L4 (last visited Mar. 9, 2006).

⁵⁰ "Two different prices for cash and credit sales are allowed on condition that either of the two options is specifically elected by the customer. Once the price is fixed, it can neither be increased because of late payment, nor decreased on earlier payment." USMANI, *supra* note 36, at 67.

⁵¹ Note that this does not violate the fourth practical guideline of Islamic finance (prohibition of uncertainty in transactions) because the profit amount and rate is predetermined and the parties know in advance the terms and conditions of their contract.

difference between the traditional interest-bearing loan and the Murabaha transaction is the source of the profit derived.

B. *Variant Forms of the Murabaha Transaction*

Other forms the Murabaha transaction may take include that of an agency sales contract or a specialized land sales contract. An agency contract mirrors the standard Murabaha transaction except that it simplifies the transaction by having either the consumer or the bank act as an agent of the other.⁵² In the agency transaction, property only transfers once between the seller and either the bank or the business owners, but not both. This variant transaction form reduces the number of parties involved in the transaction. In a standard Murabaha transaction there are three major parties: the bank acting as lender, the entrepreneur acting as borrower, and the third party from whom land or assets are being purchased. In the modified Murabaha transaction either the bank or the borrower will act as agents for each other and will contract with the third party for the purchase of the property. The agency contract condenses the transaction by combining steps in the traditional Murabaha transaction.

Another form of the Murabaha transaction is the specialized land sales contract. This transactional form is rare, but generally takes the form of a direct negotiation between the buyer and seller.⁵³ In this transaction title is transferred from the seller directly to the buyer. The seller agrees to a deferred payment schedule and the buyer makes monthly payments to the seller.

C. *The Ijara Transaction*

The second major form of financing in Islamic finance is the Ijara transaction. This transactional form is most similar to a lease-to-own transaction.⁵⁴ Specifically, a business owner would select an asset or a parcel of real estate, the bank would buy that property, and then both would enter into a lease agreement.⁵⁵ The terms of the agreement would provide that the bank agrees to sell the property to the business owner and the business owner agrees to buy the property. The business owner then makes periodic payments to the bank. There are two portions to the periodic payments, one represents the rent due and the other is a contribution to a fund that will help the business owner buy the property from the bank at the end of the contract period.⁵⁶ The business owner usually makes a large

⁵² THOMAS, *supra* note 44.

⁵³ *Id.* at 7.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

initial payment to the savings fund, which enables the fund to grow substantially through periodic contributions and investment accretion.

The Ijara transaction form differs from the traditional lease-to-own transaction because the ownership determination is based on ownership equity. In an Ijara transaction the bank holds majority equitable ownership at the beginning of the transaction period. Over time, as the business owner makes payments, majority equity ownership gradually shifts from the bank to the business owner until he owns all of the property interest. In a traditional lease-to-own transaction equitable ownership is not the sole determinant of ownership; the contract determines the ownership scheme. Some contracts provide that ownership transfers only upon receipt of all payments. The implication of such terms is that a business owner could, in theory, make all payments except the last one and still lose title to the property. Ijara transactions, in contrast, focus on the equities of the transaction.

The most common form of the Ijara transaction takes the form of a shared equity partnership arrangement. In this form of the Ijara transaction, the bank and business owner form a limited partnership or a joint venture to buy an asset or property, then the partnership rents it out to the business owner. The portion of the rent payments that represent what in a traditional transaction would be mortgage re-payment increases the business owner's equity in the property so that, over time, ownership interest transfers from the bank to the business owner. This transaction is mutually beneficial to the parties involved because the business owner obtains the necessary financing and the bank receives periodic rental payments based on a pre-approved schedule.

Another common form of the Ijara transaction occurs in the construction finance setting. In this variation of the Ijara transaction, instead of the bank buying land or an asset, the bank finances the construction of a building.⁵⁷ After the building is built the bank can either sell the building outright to the business owner or both parties may enter into a lease-to-own arrangement.

V. TAX CONSEQUENCES

The tax consequences of each transaction form are important to consider because the tax treatment of a transaction will ultimately decide its use. As neither the Murabaha nor Ijara transactional forms have become mainstream transactions their tax treatment in the U.S. is not definitive. However, both transactions have been modeled in the United States and have received favorable tax treatment.⁵⁸

⁵⁷ THOMAS, *supra* note 44, at 11.

⁵⁸ *Id.*

In the Murabaha transaction deductions are allowed for amounts paid above the base cost of the property in question.⁵⁹ The cash streams and transactional structure of the Murabaha transaction are similar to traditional interest-bearing loans and are treated the same for tax purposes.⁶⁰ Just as the interest portion of loan payments is deductible, the markup portion of each periodic payment is also entitled to a deduction.⁶¹ The excess paid represents the agreed upon markup but has been deducted and given similar treatment as interest paid. The Murabaha transaction is an attractive option for both Muslim business owners and the banking community because it allows lenders to be compensated for the money lent, and it allows borrowers access to a financing option with favorable tax treatment that is compatible with their religious beliefs. The tax advantage of the Murabaha transaction not only provides Muslim business owners with an Islamic-compliant financing option, but also one that is competitive with traditionally Western modes of financing.

The Ijara transaction has somewhat less concrete tax treatment. Although there is no explicit tax deductibility, deductions may be implicit.⁶² Some home finance groups have adopted the Ijara structure to allow prospective Muslim homeowners to finance their home purchases.⁶³ Although the IRS has never explicitly allowed deductions in this setting, these home finance companies have notified the IRS of their practices and the IRS has not intervened.⁶⁴

VI. BANKING INDUSTRY'S INCENTIVE FOR CHANGE

Although the suggestions for accommodation in the banking industry are motivated to level the financial playing field for Muslim-American entrepreneurs, the suggested accommodations also offer incentives for the mainstream banking community. The incentives for the banking industry to accommodate Muslim entrepreneurs' banking needs are great. It is a well-known fact that Islam is the second largest of the world's religions and there is a large population of Muslims here in the United States, which is estimated at 3 million.⁶⁵ All of these Muslims have banking needs, whether for individual or business services. By making

⁵⁹ *Id.* at 5. The Murabaha transaction has been successfully implemented in the United States in the area of home financing. When individuals enter into such transactions to finance the purchase of a home, they are allowed to take deductions in the amount of their periodic payments that represent excess of the base cost of their property.

⁶⁰ *Id.*

⁶¹ *Id.* at 6.

⁶² *Id.* at 9.

⁶³ See generally Guidance Financial: Home Ownership—The Sharia Way, <http://www.guidancefinancial.com/products/IslamicHomeFinancing.asp>.

⁶⁴ *Id.*

⁶⁵ CIA World Factbook, available at <https://www.cia.gov/cia/publications/factbook/geos/us.html#People> (last visited April 16, 2007).

slight accommodations American banks can capture an untapped source of business from a population that, for religious reasons, has traditionally been underserved. Beyond the pure economic incentive the banking community should make accommodations for Shariah compliant banking and financial services because Muslim Americans are entitled to equal financing opportunities without having to compromise their religious beliefs.

Introducing the Murabaha and Ijara transactions to the mainstream banking community promotes the principles of banking regulations by requiring equitable contracts, providing tax benefits, and including all members of society.

VII. THE U.S. BANKING SYSTEM TODAY

A. *The Dual Banking System and Regulatory Schemes*

Banks in the United States generally fall into two categories: those that are nationally chartered and those that are state chartered. Banking law allows individual banks to choose the regulatory scheme by which they will abide.⁶⁶ A bank can choose to be nationally chartered and be regulated by the Comptroller of Currency ("OCC").⁶⁷ Alternatively, a bank can choose to be state chartered and regulated by the appropriate state agency.⁶⁸ In addition, if a state chartered bank so chooses it may also be subject to federal regulation by joining the Federal Reserve system (the "Fed"). Both state and nationally chartered banks may also be regulated by the federal system if they are insured by the Federal Deposit Insurance Corporation ("FDIC"). The various banking regulatory regimes form an interesting patchwork of law that often overlaps. A nationally chartered bank that is FDIC insured will be subject to OCC and FDIC regulation. Similarly, a state bank that is FDIC insured can be subject to regulation by the state, the FDIC, and the Federal Reserve Board at one time.⁶⁹

Giving banks their choice of regulatory regimes creates competition between the state and federal regulatory schemes.⁷⁰ Banks naturally charter with the regime that poses the fewest obstacles.⁷¹ In enacting banking legislation Congress adopted a policy of "competitive equality," whereby national banks were not afforded any competitive advantage over state banks.⁷² The overall policy goal is to level the playing field for both state

⁶⁶ SARKIS J. KHOURY, U.S. BANKING AND ITS REGULATION IN THE POLITICAL CONTEXT 25 (1997).

⁶⁷ Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988).

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ KHOURY, *supra* note 66.

⁷¹ *Id.*

⁷² Edward L. Rubin, *Automated Teller Machines and the Midland Decision*, 44 BUS. LAW. 1082 (1989).

and nationally chartered banks so neither is able to dominate the market.⁷³ This policy extends to states in the fight against protectionism and favoritism. Under the competitive equality policy, regardless of a state's banking policy, the state is not permitted to enact legislation operating to the disadvantage of national banks.⁷⁴ The effect of regulatory competition between the state and federal system is that regulatory parity is achieved because neither system will allow the other any great departure from the status quo for fear of losing charters from their own system.⁷⁵ The following sections will discuss the permissible activities of both national and state banks and see if the proposed accommodations fit into the larger regulatory scheme.

B. *Permitted Activities for National Banks*

The National Bank Act (the "NBA" or "Act"), enacted in 1864, established the Office of the Comptroller of Currency to charter and regulate national banks.⁷⁶ The Act, as amended, confers broad authority on banks to engage in any activity necessary to the "business of banking."⁷⁷ The OCC, as duly appointed regulator of the national banking scheme, is charged with interpreting the NBA and determining what activities fall within the contemplated meaning of the Act and what activities fall outside the scope of the Act.⁷⁸

⁷³ See Donald C. Langevoort, *Interpreting the McFadden Act: The Politics and Economics of Shared ATMs and Discount Brokerage Houses*, 41 Bus. Law. 1265 (1986).

⁷⁴ *Id.*

⁷⁵ KHOURY, *supra* note 66.

⁷⁶ ANN B. MATASAR AND JOSEPH N. HEINEY, *THE IMPACT OF GEOGRAPHIC DEREGULATION ON THE AMERICAN BANKING INDUSTRY* 3 (2002).

⁷⁷ 12 U.S.C. § 24 (2006) provides in relevant part:

Upon duly making and filing articles of association and an organization certificate the [national banking] association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power—
Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title.

12 U.S.C. § 24(Seventh) (2006).

⁷⁸ "It is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an

The term “business of banking,” as codified, has been interpreted by courts broadly to confer extensive discretionary authority upon the OCC.⁷⁹ Three major principles have emerged from common law precedent to interpret the “business of banking” language.⁸⁰ The principles used to evaluate an activity as within the scope of the “business of banking” are: “[1] is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; [2] would the activity respond to customer needs or otherwise benefit the bank or its customers; and [3] does the activity involve risks similar in nature to those already assumed by banks.”⁸¹

In addition to the use of the above-outlined principles in determining whether a banking activity is acceptable, the OCC publishes a list and description of activities permissible for national banks every year.⁸² Of concern to the present discussion is whether the OCC considers equity investments in assets or real estate within the purview of the Act, such that those investments would be acceptable activities for banks by relating to the “business of banking.” Although the 2005 guidelines for acceptable activity limit real estate investments for national banks to “special circumstances,” other acceptable investments are similar to the type of investments proposed such that an equity investment accommodation for Muslim entrepreneurs would not be a departure from the normal practices of banks.⁸³ The guidelines detail the acceptable investment activity for national banks.⁸⁴

Many of the allowable investments outlined in the guidelines are specialized securities, but some of the permitted investment activity involves supporting community development and limited real estate ownership.⁸⁵ The allowable investments related to community

extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws.”

Clarke v. Securities Industry Ass’n, 479 U.S. 388, 402-04 (1987) (quoting *Investment Company Inst. v. Camp*, 401 U.S. 617, 626-27 (1971)).

⁷⁹ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *4 (OCC) (citing *NationsBank of North Carolina, N.A. v. Variable Life Annuity Co.*, 513 U.S. 251 (1995)).

⁸⁰ *Id.*

⁸¹ *Id.* at *4 (OCC) (citing *Merchants’ Bank v. State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp. v. Seattle First Nat’l Bank*, 563 F. 2d 1377 (9th Cir. 1977), cert denied, 436 U.S. 956 (1978); *American Ins. Ass’n v. Clarke*, 865 F. 2d 278 (2d Cir. 1988)).

⁸² OFFICE OF THE COMPTROLLER OF CURRENCY, ACTIVITIES PERMISSIBLE FOR A NATIONAL BANK (2006).

⁸³ *Id.* at 62. The relevant language provides in part: “Aside from property necessary for the transaction of its business, the authority of national banks to purchase and lease real estate has been limited to special circumstances...” *Id.*

⁸⁴ *See id.*

⁸⁵ MATASAR AND HEINEY, *supra* note 76, at 49-65.

development are aimed specifically at low-income areas.⁸⁶ For example, one such activity is an investment in an “entity that will purchase, construct, and operate an ethanol plant that is located in a low- and moderate-income geography and will provide jobs to unskilled individuals.”⁸⁷ Another allowable activity permits banks to invest in “financing source[s] for charter school facilities.”⁸⁸ Yet another allowable investment activity permits banks to extend small loans to low-income parents who are making the shift from welfare to work life.⁸⁹ More important than the technicalities of the allowable community development investments are their underlying aim and purpose. These investments are allowable because they provide financing for individuals and initiatives that traditional financing institutions would shy away from because of the risk involved or the low rate of return. Two principles of the OCC can be discerned from the above discussion: (1) the OCC’s commitment to economic development, and (2) the OCC’s commitment to serving under-served populations.⁹⁰

The allowable real estate investments for national banks are limited by statute, but have been broadened significantly through OCC interpretive rulings.⁹¹ These real estate restrictions are particularly relevant to Muslim entrepreneurs who may need to purchase land or an office to operate their business. The rulings permit national banks to own real estate related to the bank’s premises including ownership of commercial facilities for lodging out of town visitors.⁹² The rulings further provide that excess accommodations may be extended to the general public, and to make the lodging accommodation practicable the bank may even develop and sell residential condominiums to provide financing.⁹³ The OCC interpretive rulings pertaining to allowable real estate investments show the trend towards a broadened interpretation of allowable investments in real estate.

Another allowable investment involves a non-controlling minority interest in limited liability companies.⁹⁴ However, the activities engaged in must be incidental to the business of banking. This form of investment mirrors almost exactly the financing structure for the Murabaha transaction. As previously mentioned, creating a limited liability company wherein the bank and customer share an interest is the best means of executing the Murabaha transaction. Although the Murabaha transaction and the creation

⁸⁶ OFFICE OF THE COMPTROLLER OF CURRENCY, SIGNIFICANT LEGAL, LICENSING, AND COMMUNITY DEVELOPMENT PRECEDENTS FOR NATIONAL BANKS 8 (2006)

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ See generally OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 82, at 8-9.

⁹¹ *Id.* at 9.

⁹² OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 82, at 8 (citing OCC Interpretive Letter No. 1045 (Dec. 2005) and OCC Interpretive Letter No. 1044 (Dec. 2005)).

⁹³ *Id.*

⁹⁴ OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 81, at 59.

of a limited liability company for land and asset acquisitions is not specifically contemplated by the OCC guidelines the fact that a similar activity is found to be acceptable and within the scope of the “business of banking” language is encouraging.

A similar allowable investment is the purchase of home finance products for Muslim homeowners. This type of an investment was allowed by the OCC in an interpretive letter issued to the Bank of Kuwait.⁹⁵ The Bank of Kuwait (“UBK”) wanted to extend its mortgage lending business to Muslims who for religious reasons could not participate in traditional lending activities. The OCC found that the financing structure that UBK proposed was “functionally equivalent to a financing transaction in which the [UBK] occupied the position of a secured lender . . . [and] in substance, has the characteristics of a financing transaction.”⁹⁶ Moreover, the OCC found that UBK’s financing proposal was consistent with the real estate restrictions in section 29 of the United States Code.⁹⁷ The interpretive letter explains that section 29 restrictions are aimed at: (1) keeping banking capital from flowing directly into commerce, (2) deterring banks from engaging in hazardous real estate ventures, and (3) preventing banks from amassing large amounts of real estate held to perpetuity.⁹⁸ The OCC letter goes on to explain that UBK’s Shariah compliant financing proposal for Muslim homeowners “does not conflict with any of the purposes underlying the restrictions of section 29 . . . to the contrary . . . [the] proposal creates an alternative means of providing access to credit to an un-served segment of prospective home buyers. Without the program these individuals effectively will not have access to credit.”⁹⁹

The OCC has already made several exceptions to banking law and, in particular, to the general prohibition against equity investments. The exceptions detailed above also indicate that the OCC has a general policy to accommodate under-served populations. The exceptions and accommodations the OCC has made over the years are similar to the accommodation being sought for Muslim entrepreneurs. Muslim entrepreneurs are an under-served population, who, for religious reasons, cannot participate in traditional loan transactions and deserve to be accommodated like any other under-served population. Moreover, the OCC has already made an exception to the ban on equity investments for Muslim homeowners. The Muslim home finance exception is substantially similar to the exception sought for Muslim entrepreneurs and can even be considered a mere extension of the former. In short, the OCC’s numerous exceptions and accommodations to general banking law principles illustrate

⁹⁵ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *1 (OCC).

⁹⁶ *Id.* at 8-9.

⁹⁷ *Id.* at 14; 12 U.S.C. § 29 (2006).

⁹⁸ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *14 (OCC).

⁹⁹ *Id.*

that an accommodation for Muslim entrepreneurs is reasonable and attainable.

C. Permitted Activities for Banks Subject to FDIC Regulation

National banks associated with the Federal Reserve System may make real estate loans subject to OCC conditions.¹⁰⁰ As previously mentioned, state banks that have FDIC insurance are subject to FDIC regulation. Generally, FDIC regulations promote safe banking and those activities that do not put the deposit insurance fund at great risk.¹⁰¹ The FDIC is a federal agency that plays a more reactive role to state law. For state banks state law generally determines in which investment activity a bank may engage.¹⁰² The FDIC then reviews the allowable activity and considers whether it is permissible for an FDIC insured bank.¹⁰³ The FDIC may approve or disapprove of an investment activity at its discretion and those banks with FDIC insurance are obligated to make their investments FDIC compliant.¹⁰⁴ The discussion that follows examines the statutory and regulatory law pertaining to the FDIC and allowable investment activity to determine whether the proposed equity-based transactions are permitted.

Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") in response to the Savings and Loans scandals of the late 1980's and early 1990's.¹⁰⁵ The Act sought to decrease risk in the banking system by regulating state banks that are FDIC insured.¹⁰⁶ Specifically, the FDICIA prohibits state banks from engaging in any activity from which national banks are prohibited from engaging.¹⁰⁷

¹⁰⁰ 12 U.S.C. § 371 (2006) provides in relevant part:

(a) Authorization to make real estate loans; orders, rules and regulations of Comptroller of the Currency. Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to section 18(o) of the Federal Deposit Insurance Act and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.

See also Jonathan L. Levin, *THE GUIDE TO NATIONAL BANKING LAW* 92, 93, 97 (1996).

¹⁰¹ FEDERAL DEPOSIT INSURANCE CORPORATION, DECISIONS ON BANK APPLICATIONS: INVESTMENTS AND ACTIVITIES, available at <http://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity/index.html> (last visited 3/26/06).

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ Heidi M. Schooner, *Recent Challenges to the Persistent Dual Banking System*, 41 ST. LOUIS L.J. 263, 268 (1996) (citing Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C.)).

¹⁰⁶ *Id.*

¹⁰⁷ 12 U.S.C. § 1831 provides in relevant part:

The FDICIA also prohibits state insured banks from making equity investments, either directly or indirectly, unless the investment falls within one of the qualified exceptions of the statute.¹⁰⁸ The statute provides exceptions to the no equity investments rule in three situations: (1) in a majority owned subsidiary of the bank, (2) for qualified housing purposes, or (3) in grandfathered investments.

The regulations expanding on the FDICIA explain that state banks may make equity investments in a subsidiary of the bank for which the bank holds majority ownership.¹⁰⁹ This exception merely allows banks to own equity in subsidiary companies that the bank already owns. Qualifying this

(c) Equity investments by insured State banks.

(1) In general. An insured State bank may not, directly or indirectly, acquire or retain any equity investment of a type that is not permissible for a national bank.

(2) Exception for certain subsidiaries. Paragraph (1) shall not prohibit an insured State bank from acquiring or retaining an equity investment in a subsidiary of which the insured State bank is a majority owner.

(3) Exception for qualified housing projects.

(A) Exception. Notwithstanding any other provision of this subsection, an insured State bank may invest as a limited partner in a partnership, the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation, or new construction of a qualified housing project.

(B) Limitation. The aggregate of the investments of any insured State bank pursuant to this paragraph shall not exceed 2 percent of the total assets of the bank.

(C) Qualified housing project defined. As used in this paragraph

(i) Qualified housing project. The term "qualified housing project" means residential real estate that is intended to primarily benefit lower income people throughout the period of the investment.

(ii) Lower income. The term "lower income" means income that is less than or equal to the median income based on statistics from State or Federal sources.

(4) Transition rule.

(A) In general. The Corporation shall require any insured State bank to divest any equity investment the retention of which is not permissible under this subsection as quickly as can be prudently done, and in any event before the end of the 5-year period beginning on December 19, 1991.

(B) Treatment of noncompliance during divestment. With respect to any equity investment held by any insured State bank on December 19, 1991, which was lawfully acquired before December 19, 1991, so long as the bank complies with the applicable requirements established by the Corporation for divesting such investments.

¹⁰⁸ *Id.*

¹⁰⁹ Activities of Insured State Banks, 12 C.F.R. § 362.3(a)(2) (2007).

exception is the rule that the majority owned subsidiary exception is conditioned on the subsidiary not engaging in any activity in which a subsidiary of a national bank may not engage.

The second major exception to the FDICIA's equity investment prohibition is that banks are allowed to make equity investments in qualified housing projects intended to benefit lower income individuals. State banks may make equity investments in housing projects as a limited partner in a partnership or own an interest in a limited liability corporation. One restriction to this exception is that the state banks' aggregate investment in the housing project may not exceed two percent of the total assets of the bank.¹¹⁰

The third and final exception to the FDICIA's no equity investments rule is that banks can retain existing grandfathered investments in common or preferred stock listed on a national securities exchange. Banks have to file notice with the FDIC and may continue to acquire stock unless the FDIC objects.

VIII. RETHINKING THE PROHIBITION AGAINST EQUITY INVESTMENTS

Although Congress was justified in enacting the FDICIA in light of the Savings and Loans scandals it is far too sweeping for today's banking needs as illustrated by the restriction on equity investments. Some critics of the act say the FDICIA weakens the traditional dual banking system by significantly constricting state banks' independent investment decision making.¹¹¹ These critics argue that the importance of the dual banking system lies in basic federalism concepts. The FDICIA dances dangerously close to infringing on individual states' rights to regulate state banks the way they choose. The FDICIA reduced insured state banks' independence by requiring banks to adhere to national banks' investment guidelines.¹¹² The rationale for the decreased independence may be that state banks affect the national economy and banking system and therefore need to be regulated so as not to disturb the national and global banking systems. Regulators have a natural interest in maintaining a smooth functioning banking system, but the cost of the intensified regulation of state banks may be a loss of innovative and high-return investments, as well as the loss of lucrative business from potential clients.

Although the dangers cited by the critics against the extended breadth of the FDICIA are based on federalism principles, their assertion is duly noted. State banks are often referred to as "laboratories for innovation;" as such, if a state bank chooses to adopt policies that are compliant with national banking law principles—even though not expressly

¹¹⁰ *Id.*

¹¹¹ SCHOONER, *supra* note 105, at 268

¹¹² Federal Deposit Insurance Corporation Act, 12 U.S.C. § 1831(a) (2006).

permitted—state banks should have the authority to do so as long as such policies do not violate the principles of banking law.¹¹³ However, the critics are intuitively correct in addressing the need for change in existing banking law. Although they suggest the change should be in the form of less federal regulation and more individual state regulation, a change is most uniformly and efficiently achieved through federal avenues.

Another danger within the FDICIA is the no-equity investment rule as it applies to insured state banks. The no-equity investment provision prevents Muslim business owners who would go through state bank avenues to obtain equity investments for their land or asset acquisitions from securing acceptable financing for their business through equity means. Islamic law requires that banks make equity investments in the item being acquired—be it land or an asset—and the business owner buys it back from the bank. The current financing options available present a dilemma for the Muslim business owner who must either violate religious tenets, and take an interest-bearing loan to finance the desired acquisition, or comply with his or her religious convictions and forego traditional financing vehicles.

The banking community can accommodate Shariah compliant transaction structures and further promote the goals of the statutes that govern the industry. As previously mentioned, the FDICIA was enacted in light of the Savings and Loans scandals of the 1980s and 1990s.¹¹⁴ One goal of the regulation was to prevent banks from becoming private real estate companies.¹¹⁵ If the Murabaha and Ijara transactions are introduced into the mainstream banking community they will enable that banks maintain their current role as financier and not become too involved in private real estate. In every Murabaha and Ijara transaction the banks act as a limited partner in a partnership with the entrepreneur acting as general partner.¹¹⁶ The role of the bank is that of a financier and the contract between the bank and entrepreneur provides that the property in question is always sold to the business owner in the end. Thus, these transactions allow Muslims to obtain financing and further the goals of existing banking law.

IX. IS EQUITY-BASED ENTREPRENEUR FINANCING PERMISSIBLE UNDER CURRENT BANKING LAW?

¹¹³ Jabari M. Vaughn, *New and Foreign Banking Markets: Achieving the American Dream: May Financial Holding Companies Engage in Real Estate Brokerage?*, 9 N.C. BANKING INST. 443 (2005) (citing Federal Reserve Board and Treasury Department Rule Proposal: Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the House Comm. on Fin. Serv., 107th Cong. 61 (2001)).

¹¹⁴ SCHOONER, *supra* note 105.

¹¹⁵ *Id.*

¹¹⁶ An LLC model has more recently replaced the partnership model. Banks enjoy limited liability and the daily management of the LLC is carried out by the entrepreneur.

The above discussion provides a general overview of banking law and permissible investment activities under current banking law. It is still unclear whether the equity based transactions for Muslim entrepreneurs proposed earlier are permissible activities for state and national banks. At first blush, it seems there is no express provision that would allow the equity-based financing. However, a closer review of the issue in light of the relevant authority mentioned above may reveal otherwise. Moreover, if such financing is not expressly allowed the proposed structures are not a large departure from the current state of law such that an accommodation should not be allowed, especially given the strong need and incentive for an accommodation to serve an underserved population. The discussion below determines whether equity-based financing is permissible under current law, and if it is not already permissible how it can be made permissible.

A. National Banks

As previously mentioned national banks fall under the statutory authority of the NBA and are heavily regulated by the OCC. The NBA is over one-hundred years old and confers broad authority on banks to engage in practices related to the “business of banking.”¹¹⁷ The statute itself does not expressly allow equity-based financing, but the broad authority the NBA conferred upon banks suggests that equity-based financial transactions are within the spirit of the NBA as incidental and necessary to carry on the “business of banking.”¹¹⁸ Providing financing options for a financially underserved population is within the purview of the “business of banking” language.¹¹⁹ Even if permissible this interpretation of the NBA is subject to OCC regulations, which are encouraging of interpretations that allow national banks to reach new markets and engage in transactions similar to those currently engaged in by national banks.

Although equity-based financing is not on the list of acceptable investment activities for national banks an interpretive letter shows that this subject has already been favorably considered by the OCC.¹²⁰ Several years ago the UBK posed this issue: the permissibility of equity-based financing for Muslims to the OCC.¹²¹ In concluding that equity-based home financing for Muslim homeowners is a permissible investment activity for national banks the OCC used the three-pronged analysis in making its determination.¹²² As previously mentioned the determinative prongs are: “[1)] is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; [(2)] would the activity respond to customer

¹¹⁷ Corporate Powers of Association, 12 U.S.C. § 24 (Seventh) (2006).

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *1 (O.C.C.).

¹²¹ *Id.*

¹²² *Id.* at 4.

needs or otherwise benefit the bank or its customers; and [(3)] does the activity involve risks similar in nature to those already assumed by banks.”¹²³ It is only fitting then, that the three-prong analysis be extended to permit equity-based financing for Muslim entrepreneurs.

The first prong is satisfied because small business lending is a recognized banking activity. Banks provide financing to small businesses in the form of traditional business loans and extending lines of credit. National banks are authorized to make loans under the National Bank Act.¹²⁴ Moreover, courts have interpreted the Act broadly and looked at the economic substance of a transaction over its technical form in determining its permissibility.¹²⁵ Applying this principle to the issue at hand the economic substance of a traditional business loan and an equity-based financing transaction are identical. The differences between the two are technical and pertain to the structure rather than the economic substance of the transaction. If the economic substance of both transactions is the same then both transactions should be treated identically for the purposes of permissibility analysis.¹²⁶ National banks are explicitly authorized to make loans because traditional business loans are an acceptable activity for national banks. Therefore, equity-based financing should also be an acceptable activity for national banks.

The second prong of the permissibility analysis asks whether the activity in question fulfills a customer need or otherwise benefits the bank. The U.S. is home to a large Muslim population whose banking needs are not being fulfilled because many of the traditional banking activities are not compliant with Shariah. This Note urges the banking community to carve out a small accommodation in banking law for Muslim entrepreneurs who are otherwise forced to choose between their religious beliefs and adequate financing for their small business.

The third prong looks to see whether the activity in question involves similar risks already assumed by the bank.¹²⁷ The proposed accommodations are no great departure from the normal way banks transact; the accommodations simply propose the adoption of an intermediary step that makes the transactions Shariah compliant. Moreover,

¹²³ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *4 (OCC) (citing *Merchants' Bank v. State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F. 2d 1377 (9th Cir. 1977), cert denied, 436 U.S. 956 (1978); *American Ins. Ass'n v. Clarke*, 865 F. 2d 278 (2d Cir. 1988)).

¹²⁴ Corporate Powers of Association, 12 U.S.C. § 24 (Seventh) (2006).

¹²⁵ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *5 (OCC) (citing *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F. 2d 1377 (9th Cir. 1977), cert denied, 436 U.S. 956 (1978)).

¹²⁶ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *9 (OCC).

¹²⁷ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *4, 9-10 (OCC) (citing *Merchants' Bank v. State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F. 2d 1377 (9th Cir. 1977), cert denied, 436 U.S. 956 (1978); *American Ins. Ass'n v. Clarke*, 865 F. 2d 278 (2d Cir. 1988)).

in the Murabaha and Ijara transactions the banks' financing is secured by the property being purchased.¹²⁸ Therefore, if customers default on their payment obligations the bank will foreclose on the asset and liquidate, thereby recovering its initial investment. The third prong is also satisfied because the OCC has approved similar financing structures in the home ownership setting, so the risks involved in the proposal here are similar, if not identical, to those already assumed by the bank as approved by the OCC.¹²⁹

Although the NBA or relevant regulations do not expressly authorize equity-based financing for Muslim entrepreneurs the OCC has decided favorably on equity-based financing in the setting of homeownership.¹³⁰ The equity-based financing proposed for small businesses satisfies all three prongs of the permissibility analysis and should be considered a permissible activity for national banks, as it is substantially similar to traditional bank practices. All that is needed now is for the OCC to issue an interpretive letter or ruling that extends the equity-based financing accommodation made for homeownership to the area of asset and land purchases to fulfill business needs.

B. *State Banks*

The plain language of the FDICIA prohibits insured state banks from making equity investments subject to a few exceptions outlined in previous sections.¹³¹ The FDICIA also states that insured state banks may not make any investment that a national bank is not authorized to make.¹³² Therefore, the first thing that needs to happen is an interpretive letter or ruling from the OCC stating that equity-based financing for their business ventures is permissible. Once national banks are authorized to make such investments state banks will also need the authority to engage in equity-based financial transactions. The FDICIA poses an outer limit on insured state banks, stating that state banks may not invest in those opportunities in which national banks may not invest. It seems, therefore, that even if national banks were permitted to extend equity-based financing to customers, state banks may not be authorized to do the same without state law authorization or authorization from the FDICIA. Therefore, in addition to national bank authorization, state banks also need express authorization to provide Muslim customers with equity-based financing opportunities. The following section proposes an amendment to the FDICIA to accommodate equity-based financing for Muslim entrepreneurs.

¹²⁸ Interpretive Letter No. 806 (Oct. 17, 1997), 1997 WL 819830 at *9 (OCC).

¹²⁹ *Id.*

¹³⁰ *Id.* at 1.

¹³¹ Federal Deposit Insurance Corporation Improvement Act, 12 U.S.C. § 1831 (2006).

¹³² 12 U.S.C. § 1831(a) (2006).

C. Proposed Amendment to the FDICIA

The FDICIA is important legislation and contains many safeguards to ensure the overall health of our banking system. All that is proposed is a minor addition to the language of the statute in subsection (c), to provide another exception to the prohibition of equity investments. The exception sought is narrow in scope, well defined, and would not disrupt the functioning of the banking industry. The proposed amendment would read as follows:

(5) Exception for accommodating certain religious groups.

(A) In general. An exception to the prohibition on equity investments shall be made for religious groups whose beliefs do not permit the use of interest-based financing. Banks shall provide equity-based financing options for the members of such religious groups.

(B) These provisions are subject to relevant regulatory authority.

The proposed amendment to the FDICIA is sufficient to solve the Muslim entrepreneur-financing dilemma and sufficiently narrow in scope such that existing law and traditional banking practices are left undisturbed. With this proposed amendment, insured state banks would be authorized to engage in equity investment transactions with Muslim entrepreneurs.

X. CONCLUSION

It is imperative that the banking community make accommodations in existing law to provide Muslim entrepreneurs with Shariah compliant financing vehicles. An OCC ruling and an amendment to the FDICIA will allow American banks to structure transactions and provide financing vehicles for Muslim entrepreneurs who for religious reasons choose not to obtain traditional interest-bearing loans. Our country has long enjoyed a history of religious tolerance and accommodations. This Note provides a solution to the financing dilemma experienced by Muslim entrepreneurs by proposing an accommodation in existing banking law consistent with the goals of current banking law. The recommendations put forth in this discussion provide substantial benefits to the American Muslim population without disturbing traditional banking principles, all while providing banks with future business and a new source of profits.